

## **Background Information on the Proposed Regulations and Notice Providing Guidance on the Student FICA Exception (Section 3121(b)(10) of the Internal Revenue Code)**

### **The issue:**

- Often schools, colleges and universities employ students on a part-time or intermittent basis. Many of these students qualify for a statutory exception to FICA taxes and those work periods are not credited to the earning of social security and related benefits. In two cases heard by the United States district court in Minnesota, the question arose whether employees performing services in the nature of on-the-job training are students and thus not subject to FICA taxes. The University of Minnesota claimed that medical residents working in a hospital setting can qualify for the student FICA exception, and won both in the district court and the Eighth Circuit. The second taxpayer, Mayo Clinic, won in the same district court.
- As a result of the court decisions, many taxpayers have inquired about the application of the student FICA exception. In addition, many universities and hospitals that employed medical residents, and individual medical residents, have filed claims asking for refunds of FICA paid.

### **Guidance provided by Treasury and the IRS:**

- To clarify the exception to withholding and paying FICA taxes for students, Treasury and the IRS have issued proposed regulations, effective February 25, 2004, and a Notice containing a proposed revenue procedure providing guidance on this subject. The regulations and the notice are intended to give schools, colleges, and universities, and their employees, more specific information about when their employees can qualify for the student FICA exception and when they cannot.
- **The regulations:** The regulations provide guidance on whether an organization is a “school, college or university” and whether an employee is a “student” for purposes of the student exception from employment taxes. The regulations affect a significant number of taxpayers (not just medical residents) and include examples that cover a wide array of situations, ranging from the undergraduate student working part-time in the administration office, to graduate teaching assistants, to students getting on-the-job training at a cosmetology school, to medical residents and other professionals in training. The following summarizes the main provisions for the regulation:
  1. A school, college, or university must conduct educational activities as the organization’s primary function.

2. The employee must be enrolled and regularly attending classes in pursuit of an educational credential.
3. An individual is a student if education, as compared to employment, is the predominant aspect of the employee's relationship with the employer. The employment aspect of the relationship is considered predominant in the case of a career employee. Thus, an institution **cannot** apply the student FICA exception to a *career employee*. A career employee is an individual who –
  - a. regularly works 40 or more hours per week;
  - b. is a *professional employee*. A professional employee is an employee whose primary duty consists of performing services that require advanced knowledge in a field of science or learning, whose work requires the consistent exercise of discretion and judgment, and whose work is predominately intellectual and varied in character;
  - c. is eligible to receive certain retirement and other employee benefits, or is classified by the employer as a career employee;
  - d. is required to be licensed under state or local law in order to perform the services provided to the school, college, or university.

- **The notice:** Since 1998, Rev. Proc. 98-16 has provided institutions of higher education with an administrable mechanism for applying the student FICA exception to a student employee who is enrolled at least half-time and is not a career employee. The purpose of the notice is to suspend Rev. Proc. 98-16 and to propose replacing it with an updated revenue procedure which is consistent with the proposed regulations.
- **The proposed revenue procedure:** The updated proposed revenue procedure makes certain changes to align it with the proposed regulations. The proposed revenue procedure provides that the safe harbor applies only if the employer is a school, college, or university under the primary function standard. In addition, the safe harbor applies only if the employee is not a career employee (based on hours worked, whether the employee is a professional employee, benefits eligibility, and whether the employee is licensed to perform the services).

**Impact of the guidance:**

- Schools, colleges, and universities, and their students, may rely on the updated revenue procedure, pending a final revenue procedure, and, generally, can continue to administer the student FICA exception as they have since 1998.

- In response to the refund claims submitted, the IRS is currently developing a resolution program for this area and intends to announce the details of that program publicly within 90 days.

**Public comment and questions:**

- The public is invited to send comments on the proposed regulations and the updated proposed revenue procedure. The IRS will consider these comments before finalizing the regulations and issuing the final revenue procedure.
- Questions about the application of the student FICA exception are linked by law to questions about eligibility for Social Security benefits, including disability benefits, survivorship benefits, and retirement benefits. The IRS and Treasury are coordinating with the Social Security Administration, which has jurisdiction over the law with respect to eligibility for Social Security benefits.